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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington DC 20554

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In the Matter of	)	
	)	
Implementation of Sections of	)	
the Cable Television Consumer	)	MM Docket No. 93-215
Protection and Competition Act	)	
of 1992	)	
	)	
Rate Regulation	)	

REPLY COMMENTS OF THE AERIE GROUP INCORPORATED

I. THE BENCHMARKS MUST BE REVISED

There was an implicit consensus among almost all commenters that the system of benchmarks and the details of the "backstop" provided by cost-of-service proceedings are inextricably interrelated. If the benchmarks are wrong, the system of cost-of-service regulation cannot achieve Congress' goals.

As The Aerie Group showed in its initial comments, the Commission cannot realize Congress's commitment to reduce rates to competitive levels without increasing the benchmark from 10 percent to approximately 22 percent for the basic tier. The 10 percent benchmark is unrealistically low, primarily because it includes low-penetration systems and "pseudo-low penetration" systems as "competitive." These systems have significantly higher rates than non-competitive systems. This partially offsets the rates of truly competitive providers, which have rates 22 percent lower than comparable noncompetitive systems.

In an order issued just two days after comments in this proceeding were filed, the Commission determined to continue to include these low-penetration systems. FCC 93-428. There are both procedural and substantive reasons to revisit this decision.

In establishing this proceeding on July 15, 1993, the Commission explicitly "incorporate[d] by reference petitions for reconsideration," which raised, among other matters, the impact of including low penetration systems. FCC 93-353 at 6 & n.10. The Aerie Group and other intervenors refrained from ex parte communications in the reconsideration proceeding in reliance on this "incorporation" of issues within this docket. The Commission cannot properly fail to consider these comments after having induced parties to make them within the framework of this proceeding.

Substantively, the classification of low-penetration systems as "competitive" cannot stand a test of rationality. Low-penetration systems have higher rates, not lower rates; they are not models for noncompetitive systems. Nowhere did Congress, which used "effective competition" as a term of art to exclude certain firms from regulation, instruct the Commission to include these low-penetration firms in the calculation of a benchmark. To the contrary, Congress told the Commission to consider only "the rates for comparable cable systems subject to effective competition." H. Conf. Rept. 102-862 at 61. Low-penetration systems are not "comparable" to other noncompetitive systems. They are not models for competitive pricing, as are the systems with actual competition from overbuilds and municipal operations.

II. THE COMMISSION SHOULD PUBLISH THE WORKPAPERS UNDERLYING ITS REGRESSION ANALYSIS.

On behalf of Continental Cablevision, Dr. Roddy submits "corrections" to the Commission's regression model. His description, however, makes clear that he did not replicate the same stepwise regression, which tests and discards potential independent variables. It is essential to follow a consistent protocol in selecting independent variable, particularly where, as here, there is substantial evidence of mulitcollinearity. As a result, Dr. Roddy's correction is not statistically valid.

There do appear to be anomalies in the regression model. This Commission has not published the details of its regression, including a full list of variables tested. To allow effective comment on the validity of the model, a complete specification should be made public.

III. THE NYNEX MODEL OF REGULATORY "PARITY" OVERLOOKS DIFFERENCES BETWEEN THESE INDUSTRIES, PARTICULARLY WITH REGARD TO RISK AND COST OF CAPITAL.

The Aerie Group demonstrated that the systems for regulating cable providers and telephone companies should converge (and diminish) as these industries come into direct competition. By contrast, NYNEX (and two other regional holding companies that have associated with its views) seem to assume that the full panoply of telephone company regulation should apply immediately and without significant alteration. This procrustean solution ignores differences in the history and present position of the two industries.

Even the largest cable operators do not have the financial power to engage in the anticompetitive activities that have required so much attention from this Commission with regard to certain telephone companies.
Until the Commission can demonstrate that cable operators (or a class of the largest operators) have the ability to distort competition in adjacent markets, it is not appropriate to apply the full protections of affiliate transactions rules. As cable companies diversify into new telecommunications services, it

may be necessary to develop cost allocation principles, but these will surely diverge from the specific rules applicable to telephone companies.

The most troubling fallacy that NYNEX suggests relates to cost of capital. The system of cost-of-service will need to resolve this issue, at least provisionally, as soon as possible. Dr. Van Der Weide purports to calculate the cost of equity based on S&P Industrials, which are on average much less leveraged than cable operators. He then applies this weighted cost to the actual, highly leveraged structure of the largest cable companies. Finally, he proposes that the resulting rate of return (8.83 percent) apply across the board to cable companies in disparate risk categories. (Oddly, Dr. Van Der Weide recommends much higher rates of return for telephone companies, despite the fact that their risk is much lower.)

Dr. Van Der Weide's result ignores the well-known Modigliani-Miller theory, which states that highly leveraged companies have a higher cost of equity. This is because the equity holders have much greater risk. According to Modigliani and Miller, whose theory does not consider the tax benefits of debt, a company should be indifferent to its capital structure, since the increased weighted cost of reducing the residual equity will exactly offset the reduced weighted cost of increase debt. For this reason, the Commission cannot mix and match. It cannot use the cost of equity from low-leverage companies and the actual debt-equity ratios from cable operators.

There is a significant danger that the failure to recognize company-specific risk characteristics will lead to unintended consequences. Because of their small size, or greater exposure to competition, some firms may have risks that cause investors to demand a higher yield. To restrict these companies to an industry average (or the much lower levels that Dr. Van

Der Weide proposes) would induce non-economic acquisitions. At Dr. Van Der Weide's proposed rates of return, it may be that the only investor capable of owning certain cable operations is a telephone company -- because they can subsidize the cost of capital with the significantly higher rates of return that state commissions allow in their core activities.

IV. THE EXCLUSION OF EXCESS ACQUISITION COST IS NOT CONFISCATORY.

Without a single legal citation, the California Cable TV Association (CCTVA) asserts that the exclusion of excess acquisition cost is "constitutionally inappropriate." Comments at 43. According to CCTVA, "before the 1992 Act there were no expected prohibitions against the recovery of cable acquisition premiums." The factual assertion and the legal assumption underlying this conclusion are both incorrect.

The states (and the federal government) do not violate due process when they impose new restrictions on the use of assets that reduce their economic value. Lucas v. South Carolina Coastal Council, 120 L.Ed 2d 728, 821 (1992). It is especially clear that the Constitution permits a system of utility rate regulation to result in a "diminution of property values and income." Colorado Interstate Gas v. Federal Power Commission, 324 U.S. 581, 625 (1945). Indeed, it is the purpose of every system of utility regulation to exclude the impact of monopoly power from the prices of a regulated firm.

Even if an expectation that monopoly profits would continue indefinitely were constitutionally protected, which it is not, CCTVA makes no attempt to demonstrate that the possibility of cable reregulation was unforeseeable at any point in time. Much less can CCTVA defend the bold claim that there was no expectation of curbs on cable TV prices "before the

1992 Act." Properly informed investors were well always aware that cable could be reregulated. To the extent that they failed to consider this possibility, their payment of excessive premiums at acquisition was an imprudent business decision. It serves no economic purpose to require today's ratepayers to indemnify the investors for their past errors.

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